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Texas Margin Tax: Potential Planning Opportunity Involving Termination of Limited Partnership Structures by June 30, 2007

This article discusses a potential margin tax planning opportunity for companies conducting business in Texas through a limited partnership structure. Such entities may be able to terminate their partnership status prior to June 30, 2007 and continue their business in a different legal entity form, and thereby avoid margin tax on activities prior to termination.

In 2006, Texas enacted legislation that modified the state's franchise tax to remove the tax imposed on earned surplus or taxable capital and to impose tax based on net taxable margin (Texas-based revenue less limited deductions). This new law (commonly referred to as the "margin tax") takes effect on January 1, 2008 and is imposed for the privilege of conducting business in Texas on or after that date.

A significant change from the prior taxing system is that the new margin tax applies to a broader base of taxpayers, including limited partnerships, limited liability partnerships, business trusts, and certain other entities ("Newly Taxable Entities"). This change is expected to affect many Texas businesses that have been doing business in Texas in limited partnership form. Under the prior taxing system, limited partnerships were not subject to franchise tax. By holding 99% or more of the limited partner interests in an out-of-state entity (typically organized in Delaware or other tax friendly jurisdiction), the business avoided tax on 99% (or more) of the income transferred from the parent company to the limited partnership. In contrast, under the new Texas margin tax, the Texas limited partnership structure is ineffective because the limited partnership is subject to tax on its net taxable margin.

A pending amendment to the margin tax (H.B. 3928) would

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impose margin tax on Newly Taxable Entities that terminate after June 30, 2007 and before January 1, 2008. We expect that the Texas Comptroller will interpret this transition rule to exclude from taxation activities of Newly Taxable Entities that terminate before June 30, 2007. For an entity reporting income on the basis of a calendar year, this would allow the entity to avoid margin tax for the period from January 1, 2007 through the date of termination.

If the pending amendment is enacted as currently drafted, and assuming the Comptroller interprets the amendment as indicated, limited partnerships with significant operations in Texas should consider collapsing or other otherwise terminating their limited partnership structures prior to June 30, 2007. This action will not only potentially avoid margin tax on activities prior to termination, but may also simplify the legal entity structure going forward.

There will be some costs associated with terminating a limited partnership structure, including legal costs to prepare documents associated with the termination of the limited partnership, and legal costs and filing fees for documents required to give legal effect to the transactions. In addition, the discontinuance of the partnership operations and the continuation of those operations in the parent company or other legal entity may trigger tax and other filing requirements in states where the business is conducted. Finally, consideration should be given to whether the winding up and termination of the partnership and continuation of its business in a different state law legal entity could give rise to other non-tax consequences, such as resetting the wage base for employment taxes, resetting the experience rating for state unemployment taxes, or triggering notice, consent, or termination provisions of contractual arrangements. A feasibility and cost-benefit analysis should be undertaken to ensure that the proposed transaction is feasible and that potential margin tax savings and other administrative benefits from collapsing the structure exceed the costs of effecting the termination.

Strasburger attorneys are readily available to assist in the evaluation of this opportunity and provide a cost-efficient plan to achieve these tax savings.

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